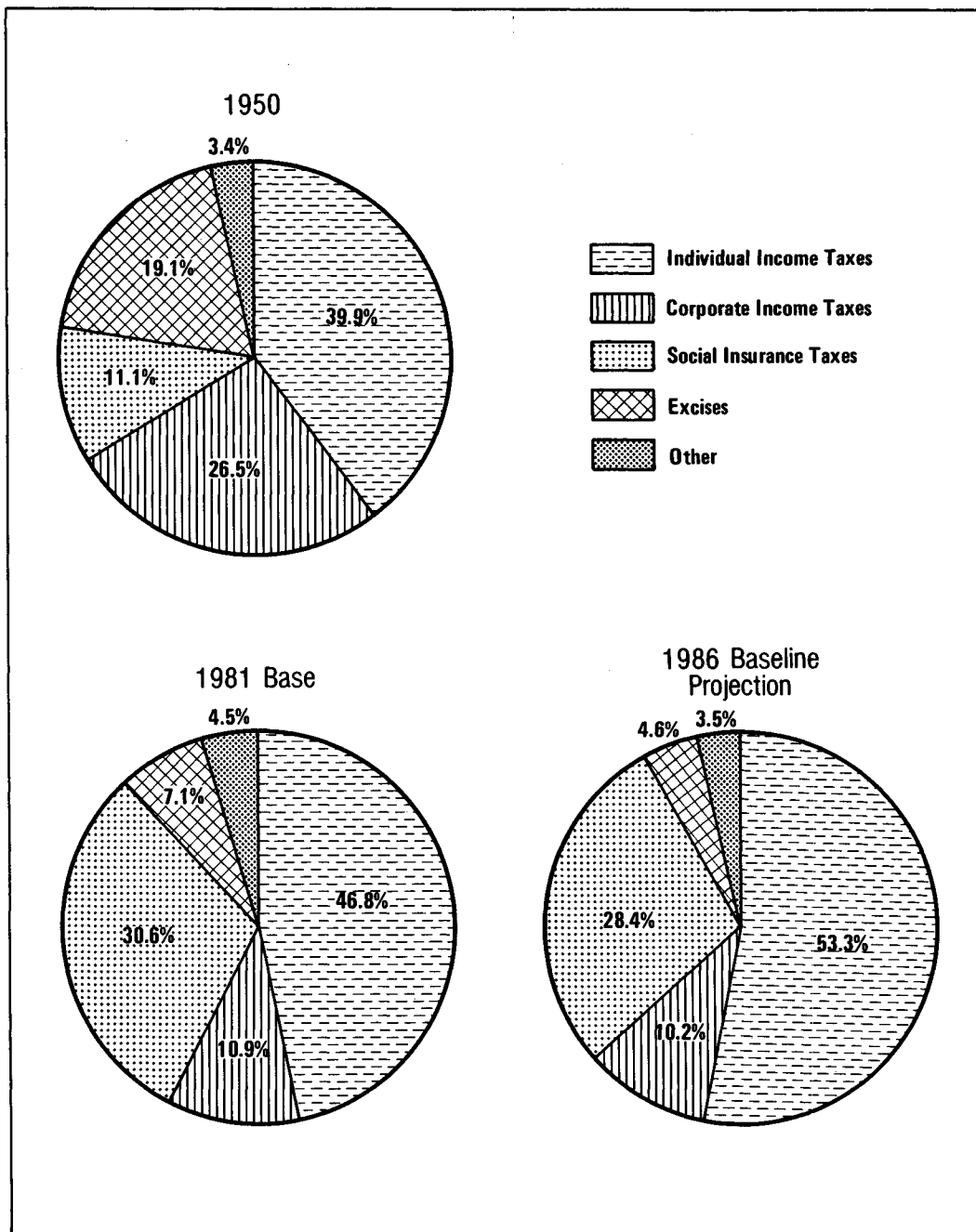


Figure 5.
The Composition of Federal Revenues



Bracket Creep Attributable to Inflation

An increase in individual income taxes of \$15.0 billion in fiscal year 1982 is attributable to bracket creep--the result of the interaction between inflation and the progressive income tax structure. The tax increase attributable to bracket creep would rise to \$51.3 billion in fiscal year 1984 and to \$97.9 billion in fiscal year 1986. Subtracting annual bracket creep from the baseline revenue projections provides another alternative revenue baseline that is useful for policy planning purposes. Such a baseline is presented in Table 10.

TABLE 10. BASELINE REVENUE PROJECTIONS WITH INFLATION OFFSETS (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
Baseline Revenues	611.9	709.1	810.2	919.6	1,033.2	1,158.8
Bracket Creep Attributable to Inflation	--	15.0	29.2	51.3	72.8	97.9
Revenues with Inflation Offsets	--	694.1	781.0	868.3	960.4	1,060.9
Percent of GNP	--	21.5	21.5	21.5	21.6	21.8

Revenues adjusted for bracket creep represent a slightly increasing share of GNP over the projection period. These increases in the GNP share are attributable to productivity increases that give rise to increases in real incomes, which are then taxed at the higher marginal tax rates inherent in the progressive income tax system.

As mentioned above, the Congress has from time to time enacted tax reductions that have offset a substantial amount of bracket creep. Tax reductions went into effect in 1964, 1969, 1971, 1975, 1976, 1977, and 1978. Nevertheless, as shown in Figure 4, the individual income tax burden as measured by the ratio of income taxes to taxable personal income has been increasing steadily since 1977 because of the high rates of inflation in recent years. Under existing law, the tax burden would continue to increase

at historically high rates over the next five years. By fiscal year 1986, income taxes under existing law would claim 18.8 percent of taxable personal income--an increase of 57 percent in tax burden over the 20 years since 1966, when individual income taxes claimed 10.7 percent of taxable income. With offsets for bracket creep attributable to inflation after the 1981 base year, the ratio of taxes to income would reach 15.8 percent in 1986--three percentage points below the projected ratio under current law.

Scheduled Increases in Social Security Taxes

After individual income taxes, the preponderant source of federal revenues is social insurance taxes. As mentioned above, these payroll taxes have been the fastest growing source during the past 30 years. Although their share of total baseline revenues would decrease slightly over the next five years, they would be growing at a rate slightly higher than the average increase in GNP during those years.

In the 1982-1986 period, social insurance taxes would provide, on average, 29.2 percent of all federal revenues collected under existing tax law. Combined with individual income taxes, they would provide, on average, 79.9 percent of all federal revenues.

Social Security taxes, which make up over 85 percent of total social insurance taxes, account for most of the projected growth in these revenues. Both the maximum taxable wage level (base) and the tax rate for Social Security taxes will increase regularly over the next five years according to a schedule established in the 1977 Social Security amendments. The base was increased substantially in 1979, 1980, and 1981 in order to increase the percentage of earnings in covered employment that are subject to tax. Starting in 1982, the base will be indexed in order to keep this coverage percentage roughly constant. Table 11 shows the rate and base increments and the resulting revenue increases consistent with the budget resolution economic assumptions.

Without the indexing of the tax base, the effect of inflation on social security taxes would be exactly the opposite of inflation's effect on the personal income tax. In the absence of indexing, inflation would increase the portion of earnings above the social security base, and would decrease the ratio of social security to earnings and the GNP. Indexing the tax base offsets this reverse bracket creep, just as indexing the brackets in the personal income tax for inflation would mitigate bracket creep there.

Of the \$49 billion in 1986 revenues attributable to rate and base increases from 1982 forward, only \$19 billion is attributable to the sched-

TABLE 11. SCHEDULED INCREASES IN COMBINED EMPLOYER AND EMPLOYEE SOCIAL SECURITY TAX RATES AND BASES WITH RESULTING INCREASES IN REVENUES

Calendar Year	Maximum Taxable Earnings Base		Combined Employer-Employee Tax Rate		Increases in Social Security Revenues (By fiscal year, in billions of dollars)				
	Increase	Amount	Increase	Percent	1982	1983	1984	1985	1986
1982	2,400	32,100	0.10	13.4	2.1	4.9	5.9	7.1	8.3
1983	3,300	35,400	--	13.4		3.0	6.4	7.9	9.4
1984	3,600	39,000	--	13.4			3.3	6.8	8.2
1985	3,300	42,300	0.70	14.1				11.0	18.8
1986	3,600	45,900	0.20	14.3					4.5
					2.1	7.9	15.6	32.8	49.2

uled increases in the rates. The larger part--\$30 billion--is the result of the indexation of the base. Thus, the ratio of social insurance taxes to taxable income will increase only slightly during this period, from 9.7 percent in 1982 to 10.0 percent in 1986.

BUDGET RESOLUTION REVENUE TARGETS

The intent of the budget conferees was to leave room in the recommended revenue levels for the net tax reductions proposed by the Administration in its 1982 budget message. The recommended revenues, as shown in Table 12, include these tax reductions.

The budget resolution specifies net tax reductions of \$8.6 billion in fiscal year 1981 and \$51.3 billion in fiscal year 1982, and recommends net tax reductions of \$97.0 billion in fiscal year 1983 and \$144.8 billion in fiscal year 1984. These revenue reductions, along with the Administration's March tax reduction proposals, are shown in Table 13.

THE ADMINISTRATION'S MARCH TAX PROGRAM

The Administration's March tax program consisted of three annual rounds of 10 percent across-the-board reductions in individual income taxes, as well as an Accelerated Cost Recovery system for plant and equipment depreciation for tax purposes, and several relatively small tax increases,

TABLE 12. BUDGET RESOLUTION REVENUE TARGETS BY SOURCE (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Individual Income Taxes	279.6	293.5	314.5	343.7
Corporate Income Taxes	64.7	62.2	67.5	69.4
Social Insurance Taxes	187.4	216.6	241.2	265.4
Excise Taxes	43.7	55.9	57.1	58.6
Estate and Gift Taxes	6.9	7.6	8.5	9.4
Customs Duties	7.5	7.9	8.3	8.8
Miscellaneous Receipts	<u>13.4</u>	<u>14.2</u>	<u>16.1</u>	<u>19.6</u>
Total	603.3	657.8	713.2	774.8

TABLE 13. NET DECREASES IN REVENUES RECOMMENDED IN THE BUDGET RESOLUTION AND THE ADMINISTRATION'S MARCH TAX PROPOSALS (By fiscal year, in billions of dollars)

	1981	1983	1983	1984
Budget Resolution	-8.6	-51.3	-97.0	-144.8
Administration's March Tax Proposals				
Tax Cuts				
Individual	-6.4	-44.2	-81.4	-118.1
Business	-2.5	-9.7	-18.6	-30.0
Other	<u>+0.2</u>	<u>+2.6</u>	<u>+3.0</u>	<u>+3.3</u>
Total	-8.6	-51.3	-97.0	-144.8

including new user charges, an increase in railroad retirement taxes, and the extension of the highway trust fund excise taxes beyond fiscal year 1984.

The rationale for this tax program, which is heavily weighted toward individual income tax reductions, is that present marginal tax rates are impeding work effort, saving, and investment. These rate reductions are expected to generate more output growth, which can then be directed toward productive investment. In addition, the Accelerated Cost Recovery system is designed to offset the inflation-caused erosion of depreciation allowances experienced under the present Asset Depreciation Range system of depreciation.

The Administration's tax cuts would not reduce revenues from their present levels, but would lower the growth rates of taxes compared with those inherent in existing law. They would lower the average annual rate of revenue growth for fiscal years 1981-1984 from the 15.3 percent baseline growth rate to 10.5 percent. They would reduce the federal revenue share of GNP from 20.3 percent in 1980 to 19.2 percent in 1984 (see Table 14). After 1984, however, when no further rate cut is scheduled, revenues would again be increasing as a share of GNP.

TABLE 14. COMPARISON OF BASELINE REVENUES AND BUDGET RESOLUTION REVENUES AS A SHARE OF GNP (By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Baseline Revenues	611.9	709.1	810.2	919.6
Percent of GNP	21.4	22.0	22.3	22.8
Recommended Net Revenue Decrease	-8.6	-51.3	-97.0	-144.8
Budget Resolution Revenues	603.3	657.8	713.2	774.8
Percent of GNP	21.1	20.4	19.6	19.2

The Administration's tax program would also alter the relative growth rates of different types of taxes. Under the program, the growth in individual income tax receipts over the 1981-1984 period would be reduced by almost two-thirds, from 63.2 percent to 22.9 percent. The growth in corporate income taxes would be reduced even more substantially, from 40.1 percent to 7.3 percent. The growth in social insurance receipts would not be directly affected by the program.

SENSITIVITY OF REVENUE PROJECTIONS TO ECONOMIC ASSUMPTIONS

As mentioned in Chapter II, each set of budget projections depends in part on the economic developments expected during the projection period. Different economic assumptions produce a different budget, even with no changes in programs or policies. The sensitivity of revenue projections to changes in economic assumptions is discussed in some detail here. As was noted above, economy-induced effects on revenues typically exceed those on outlays.

CBO has estimated the effect on baseline revenues of one percentage point changes in three economic variables--the rates of real growth, inflation, and unemployment (see Table 15). Separate estimates have been made for one-year changes and for changes that persist throughout the projection period. Of the simulated changes, a one percentage point increase in the annual rate of inflation, beginning in 1982 and sustained throughout the period, has the largest effect on baseline revenues by the end of the five-year period--increasing fiscal year 1986 revenues by \$71 billion.

TABLE 15. THE SENSITIVITY OF BASELINE REVENUE PROJECTIONS TO CHANGES IN ECONOMIC ASSUMPTIONS (By fiscal year, in billions of dollars)

	1982	1983	1984	1985	1986
<hr/>					
Real Growth: Effect of One Percentage Point Lower Annual Rate					
1982 through 1986	-5	-12	-21	-31	-44
1982 only	-5	-7	-7	-8	-8
Inflation: Effect of One Percent- age Point Higher Annual Rate					
1982 through 1986	+5	+16	+30	+49	+71
1982 only	+5	+8	+10	+11	+13
Unemployment: Effect of One Percentage Point Higher Annual Rate					
1982 through 1986	-12	-17	-18	-20	-21
1982 only <u>a/</u>	-12	-4	+1	+2	+2

a/ Net revenue increases in later years reflect delayed increases in unemployment insurance taxes.

A one percentage point increase in the unemployment rate has the largest initial effect on revenues--a \$12 billion reduction in fiscal year 1982--but the smallest ultimate effect--a \$21 billion reduction in 1986. A one percentage point reduction in the rate of real growth has less of an effect initially than a one percentage point increase in the unemployment rate, but it has a larger effect in the latter half of the projection period.

The revenue sensitivity estimates presented here assume that the higher unemployment rate results from lower real economic growth rather than from higher productivity. The lower real growth and the higher unemployment rate cases assume that prices remain unchanged from their baseline levels. The higher inflation case assumes that productivity, real growth, and employment remain unchanged from their baseline levels.

In reality, however, changes in economic conditions do not occur in isolation. Like all components of economic performance, real output growth and inflation are interdependent in significant and complex ways. The real growth rate and the unemployment rate are both measures of the utilization of economic resources; their relationship changes over time, but they are directly linked. The revenue estimates for the set of alternative economic assumptions presented in Table 7 account for these interactions.

Inflation

Revenues increase automatically as inflation raises taxable personal and corporate incomes. Taxes rise more than in proportion to nominal income because the individual income tax is progressive. The revenue growth resulting from inflation-induced income increases typically exceeds that resulting from employment-induced income increases of the same magnitude. Inflation-induced income increases lead to higher average effective tax rates as many taxpayers move into higher tax brackets, whereas employment-induced income increases are concentrated more among new workers, who tend to be subject to lower tax rates.

It is important to note how the simplifying assumptions employed here tend to affect the revenue response estimates. If real economic growth did not remain unchanged, as assumed here, but rather were reduced by the higher inflation, the resulting revenue increases would be smaller than those shown here. Alternatively, if the inflation increase were caused by an external shock, such as an OPEC oil price increase, domestic incomes would not rise proportionately, as assumed here, and the resulting revenue increases would be smaller than those shown.

Real Growth and Unemployment

Lower real growth rates and higher unemployment rates generally result in a decrease in revenues. The weaker labor market leads to lower incomes, consumers spend less, profits decline, and wage increases are likely to be tempered. If the lower real growth were to mitigate the upward pressure on prices, income growth might also be reduced, decreasing revenues even further.

In most cases of weaker real growth, the net reductions in revenues reinforce the deficit-widening effects of the induced increases in outlays. In the case of temporary decreases in economic growth, however, the net revenue effect in later fiscal years may be positive as unemployment insurance tax rates are raised to make up for the earlier benefit increases. The estimates of revenue responses resulting from a one percentage point increase in the unemployment rate in 1982 alone shown in Table 15 reflect this possible effect.

CHAPTER IV. BASELINE SPENDING PROJECTIONS

During the past five years (1976-1981), federal budget outlays have grown by almost \$300 billion. Under the baseline assumptions, in which existing spending policies continue unchanged, federal outlays are projected to grow by nearly the same amount over the next five years (1981-1986).

This chapter presents further details on the CBO baseline spending projections for fiscal years 1982-1986, including a discussion of the major components and the sensitivity of selected spending projections to economic assumptions. It also compares the 1982-1984 spending targets specified in the First Concurrent Resolution on the Budget for Fiscal Year 1982 with the CBO baseline spending projections to illustrate the spending policy changes assumed by the resolution.

SPENDING PROJECTIONS FOR MAJOR PROGRAM CATEGORIES

Under the baseline assumptions, federal outlays are projected to grow by \$290 billion, or 44 percent, between 1981 and 1986. The largest component of this projected increase is benefit payments for individuals (see Table 16). These payments--for retired and disabled workers and their dependents, unemployed workers, veterans, and low-income families and individuals--are projected to grow by \$168 billion, or 53 percent, during the next five years under laws and policies that were in effect at the end of the 96th Congress. The next largest component is national defense programs, which are projected to grow by \$94 billion, or 59 percent, by 1986 under baseline assumptions. These two program categories account for 72 percent of total budget outlays in 1981; by 1986, they would account for 78 percent of total outlays with no change in existing spending policies, as shown in Figure 6.

Projected baseline outlays as a percentage of GNP would fall from 23.1 percent in 1981 to 19.6 percent in 1986--the lowest level since 1966 (see Table 16). Almost all of the projected decline would be in the nondefense areas of the budget, with the largest declines relative to GNP in benefit payments to individuals and net interest.

Table 17 compares the projected increases in unified budget outlays under baseline assumptions for 1982 through 1986 with increases in federal outlays for the past five years. While total outlays are projected to grow

TABLE 16. BASELINE OUTLAY PROJECTIONS FOR MAJOR PROGRAM CATEGORIES (By fiscal year)

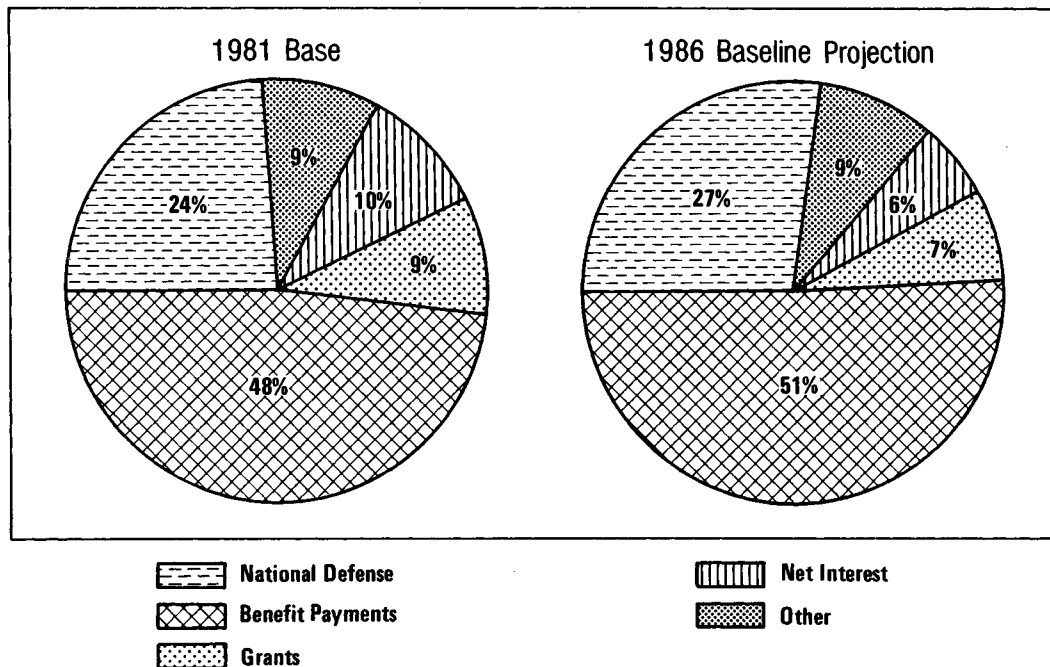
	1981 Base	Projections				
		1982	1983	1984	1985	1986
In Billions of Dollars						
National Defense <u>a/</u>	159.6	183.8	203.5	222.0	238.8	254.0
Benefit Payments for Individuals	316.1	355.9	388.6	418.8	451.8	484.0
Other Grants to State and Local Governments <u>b/</u>	56.9	58.1	60.4	63.6	67.3	71.3
Net Interest	66.1	72.4	69.7	67.0	62.3	59.1
Other Federal Operations	<u>61.1</u>	<u>68.6</u>	<u>70.2</u>	<u>72.0</u>	<u>74.7</u>	<u>81.5</u>
Total	659.8	738.7	792.5	843.3	894.9	949.9

As a Percent of GNP						
National Defense <u>a/</u>	5.6	5.7	5.6	5.5	5.4	5.2
Benefit Payments for Individuals	11.1	11.1	10.7	10.4	10.2	10.0
Other Grants to State and Local Governments <u>b/</u>	2.0	1.8	1.7	1.6	1.5	1.5
Net Interest	2.3	2.2	1.9	1.6	1.4	1.2
Other Federal Operations	<u>2.1</u>	<u>2.1</u>	<u>1.9</u>	<u>1.8</u>	<u>1.7</u>	<u>1.7</u>
Total	23.1	22.9	21.8	20.9	20.2	19.6

a/ Includes benefit payments for retired military personnel.

b/ Some grants to state and local governments are for benefit payments, such as medicaid and public assistance (AFDC). These grants are classified here as benefit payments for individuals. The other grants category covers grants for purposes such as general revenue sharing, highway construction, community development, and employment and training assistance.

Figure 6.
The Composition of Federal Spending



over the next five years by about the same dollar magnitude as the increase for 1976-1981, the annual growth rate would be lower and the composition of the growth would be different. The projected average annual growth rate for baseline outlays is 7.6 percent, considerably less than the 12.5 percent average growth rate since 1976. The projected growth rate is lower partly because interest rates, the rate of inflation, and unemployment are assumed to decline, and partly because the baseline assumptions do not provide for continuing real growth in a number of program areas. The fastest growing spending component during the past five years has been net interest outlays as a result of continuing large budget deficits and high interest rates. The baseline outlay projections for net interest decrease after 1982 because of the assumed decline in interest rates and in the deficit.

National Defense

National defense programs consist largely of the military activities of the Department of Defense. They also include programs of the

TABLE 17. PROJECTED INCREASES IN FEDERAL OUTLAYS UNDER
BASELINE ASSUMPTIONS BETWEEN 1981 AND 1986

	Actual Increases 1976-1981 <u>a/</u>		Projected Increases 1981-1986	
	Billions of dollars	Percent change	Billions of dollars	Percent change
National Defense	70.2	79	94.3	59
Benefit Payments for Individuals	139.5	79	167.9	53
Other Grants to State and Local Governments <u>b/</u>	18.9	50	14.4	25
Net Interest	39.4	148	-7.0	-11
Other Federal Operations	<u>25.4</u>	<u>71</u>	<u>20.4</u>	<u>33</u>
Total	293.4	80	290.1	44

a/ Based on 1981 estimates used for the baseline projections.

b/ Some grants to state and local governments are for benefit payments, such as medicaid and public assistance (AFDC). These grants are classified here as benefit payments for individuals. The other grants category covers grants to state and local governments for purposes other than benefit payments for individuals.

Department of Energy devoted to national defense, such as naval ship reactors and nuclear weapons, and miscellaneous defense activities, such as defense stockpiles and selective service. The CBO defense baseline projections assume an explicit defense force structure and investment program approved during the second session of the 96th Congress. 1/

Under the CBO baseline assumptions, national defense outlays are projected to grow from \$160 billion in 1981 to \$254 billion in 1986. This represents an annual average growth of 9.8 percent, which exceeds the

1/ See Appendix C for more details on the assumptions used for the CBO defense baseline projections.

assumed average rate of inflation during the projection period. National defense outlays in real terms are projected to grow by an average of about 3 percent annually. A major reason for this projected real growth is an increase in the cost of strategic forces resulting from an assumed phase-in of the MX missile and a new manned bomber. The baseline projections include all of the Carter Administration's planned outyear funding for the MX strategic missile because the 1981 defense appropriations bill included the funds requested for this new weapons system. The 1981 defense appropriations bill also added funds for a new manned bomber that would have certain specified capabilities, which CBO used to develop a five-year cost estimate. Both of these strategic weapons are under review by the Reagan Administration, and specific proposals have not yet been made.

Relative to the budget as a whole, spending for national defense would increase from 24 percent of total outlays in 1981 to about 27 percent in 1986. As a percent of GNP, however, national defense outlays under baseline assumptions would decline slightly from 5.6 percent in 1981 to 5.2 percent in 1986 (see Table 16).

Benefit Payments for Individuals

The major programs included in this category are shown in Table 18. These programs provide both direct payments from the federal government to individuals (such as Social Security benefits) and indirect payments through state and local governments (such as public assistance and child nutrition). Some programs, such as Social Security and unemployment compensation, provide cash payments to individuals to use at their discretion; other programs provide specific services used by eligible individuals (such as medical services under medicare and medicaid). The benefit payments category of spending also includes retirement pay for all federal civilian employees. Retirement benefits for military personnel are included under the national defense category.

Federal benefit payments for individuals total an estimated \$316 billion in 1981, which is 48 percent of total outlays. Most of these payments are directly or indirectly adjusted, or indexed, for inflation. Social Security benefits, for example, are adjusted automatically each year for increases in the cost of living as measured by the Consumer Price Index (CPI). Railroad retirement benefits, supplemental security income, and veterans' pensions similarly are adjusted each year for increases in the CPI. Under existing law, federal civil service retirement benefits are automatically adjusted twice a year.

TABLE 18. BASELINE OUTLAY PROJECTIONS FOR BENEFIT PAYMENTS FOR INDIVIDUALS (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
Social Security (OASDI)	138.3	158.6	176.4	191.8	207.2	222.5
Medicare and Medicaid	56.7	66.1	74.8	84.3	94.2	104.8
Unemployment Compensation	22.7	21.5	19.1	18.4	18.2	18.1
Public Assistance and Related Programs	18.8	20.5	22.4	22.0	23.6	24.6
Federal Employee Retirement and Disability <u>a/</u>	18.1	20.6	22.9	24.9	26.7	28.4
Food and Nutrition Assistance	16.3	18.0	18.8	19.6	20.3	21.0
Veterans' Compensation, Pensions, and Readjust- ment Benefits	14.9	15.7	16.5	17.1	17.7	18.3
Other	<u>30.3</u>	<u>34.9</u>	<u>37.7</u>	<u>41.6</u>	<u>43.9</u>	<u>46.3</u>
Total	316.1	355.9	388.6	418.8	451.8	484.0

a/ Excludes military retired pay, which is included in the national defense category.

Benefits for certain other benefit payment programs, while not tied explicitly to the CPI, also increase directly as a result of inflation. These include the food stamp and child nutrition programs, which are indexed to various food price indexes. Black lung benefits for disabled coal miners are adjusted automatically each year by the amount of the October pay raises for federal civilian employees. The benefit levels for unemployment insurance are tied to average earnings. Most states periodically increase aid to families with dependent children (AFDC) benefits for changes in the cost of living, although these changes have not kept pace with inflation in recent years. Finally, the cost of providing benefits in the medicare and medicaid programs rises with inflation as well, since it is the level of services and not a fixed dollar amount that is guaranteed to eligible beneficiaries. Here too,

however, reimbursement levels have not kept up with the costs of privately purchased medical care.

Under CBO baseline assumptions, outlays for benefit payments for individuals are projected to grow by \$168 billion, or 53 percent, over the next five years. This represents an average annual growth rate of 8.9 percent between 1981 and 1986, which exceeds the assumed 6.1 percent average annual increase of the CPI during the projection period. In addition to the effects of inflation, benefit payments are projected to increase because of growth in the number of retirees, disabled persons, and other individuals receiving benefits, and such factors as a rising wage base that leads to higher retirement benefit entitlements for new beneficiaries. Consequently, benefit payments for individuals as a share of the total budget would increase from 48 percent in 1981 to 51 percent in 1986, assuming no changes in existing spending policies. Relative to GNP, however, projected benefit payments for individuals would decline from 11.1 percent in 1981 to 10.0 percent in 1986.

As shown in Table 18, about half of the projected increase in this category (\$84 billion) is for Social Security benefits. Nearly 30 percent of the total projected increase in benefit payments (\$48 billion) is for medicare and medicaid, which are the fastest growing programs in this category. Unemployment compensation outlays are projected to decline during the 1981-1986 period because of the assumed decrease in the unemployment rate.

Grants to State and Local Governments

Grants to state and local governments (other than for benefit payments) make up about 9 percent of total budget outlays in 1981 (\$57 billion). Programs in this category include general revenue sharing, the Comprehensive Employment and Training Act (CETA), aid for elementary and secondary education, community development grants, grants for the construction of wastewater treatment plants, and grants for highway construction.

Under the CBO baseline assumptions, outlays for these programs are projected to rise by \$14 billion, or 25 percent, by 1986. This would represent a small decline in real terms, since outlays for a number of grant programs would not keep pace with inflation under an extension of existing laws. As a consequence, outlays for grants to state and local governments as a share of total budget outlays are projected to decline to about 7 percent by 1986.

The relatively slower growth in outlays for this category results in part from statutory ceilings for at least part of the projection period for grants for social services and general revenue sharing. Furthermore, outlays for wastewater treatment plant construction grants and community development grants are not projected to rise significantly under existing laws, even though the budget authority for these programs under the baseline assumptions is adjusted for inflation. Estimated outlays for these programs are high relative to budget authority in 1981 and the early part of the projection period because of substantial spending from prior-year appropriations.

Net Interest

The net interest category essentially represents interest paid on that portion of the federal debt held by the public. It excludes interest paid to government trust funds that hold federal securities, and includes interest payments on tax refunds and interest collections from federal agencies and the public. Net interest outlays have been the fastest growing category of federal spending since 1976, and now represent 10 percent of total outlays. As shown in Table 16, net outlays are projected to rise in 1982 and fall in 1983-1986. At the end of the projection period, net interest outlays under the CBO baseline assumptions would be somewhat less than the estimated 1981 level, and would represent 6 percent of total budget outlays.

Net interest costs depend on the level of the total interest-bearing public debt and on interest rates. The debt grows by the amount of unified budget deficits, trust fund surpluses, and deficits of off-budget agencies that borrow funds from the Treasury. For purposes of the baseline spending projections, the unified budget was assumed to be balanced beginning in 1984, and the levels of trust fund surpluses and off-budget agency deficits were assumed to be consistent with the Administration's March estimates. The substantial unified budget surpluses projected by the Administration after 1984 were not assumed to be applied to reductions in the public debt (nor to any other specific purpose). Interest rates were assumed to decline throughout the projection period, as discussed in Chapter II.

Other Federal Operations

The other federal operations category includes the remainder of the budget. The major components are farm price supports, domestic energy programs, foreign aid, general science research and space technology, housing credit activities, and the numerous civilian agency salary and

expense accounts that fund the day-to-day operations of the federal government. In 1981, this category represents about 9 percent of total budget outlays (\$61 billion). Under CBO baseline assumptions, outlays are projected to grow by \$20 billion, or 33 percent, over the next five years. This essentially would keep spending growth for this category in line with the projected rate of inflation for 1982-1986, and the relative share of the budget allocated to these programs would remain about the same.

MAJOR FUNCTIONAL CATEGORIES

An important classification of federal spending is by the major functions or purposes being served by federal programs. The Congressional Budget Act of 1974 requires the Congress to include estimates of budget authority and outlays for each major function in its annual budget resolutions. The functional classification is a means of presenting spending estimates according to the national needs that federal programs are intended to serve, regardless of the methods used to carry out the activities. National needs are grouped in 16 broad areas, ranging from national defense, international affairs, and energy programs to agriculture, transportation, health, and general government programs. Three additional categories--interest, allowances, and undistributed offsetting receipts--do not address specific national needs but are included to cover the entire budget.

Tables 19 and 20 present the baseline projections of budget authority and outlays by the 19 major functions used for Congressional budget resolutions. No funds are projected for the allowances category (function 920) because projected civilian agency pay raises, the usual item included in this category in the past, are distributed among the other categories in accordance with the convention adopted for the 1982 first budget resolution.

The largest single functional category is income security (function 600), which consists mainly of benefit payments for individuals such as Social Security and other general retirement and disability insurance, federal civilian employee retirement and disability, unemployment compensation, housing assistance, food and nutrition assistance, and other benefit programs. In 1981, outlays for this function are estimated to be \$229 billion, which represents 35 percent of total budget outlays. Under the baseline assumptions, outlays for income security programs are projected to grow by \$110 billion, to \$339 billion in 1986. As a share of total budget outlays, income security programs would increase slightly by the end of the projection period (from 35 percent in 1981 to 36 percent in 1986).

The next largest function is national defense (function 050), which makes up 24 percent of total outlays in 1981 and is projected to grow as a

TABLE 19. BASELINE PROJECTIONS OF BUDGET AUTHORITY, BY
FUNCTION (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
National Defense (050)	173.7	198.1	219.0	238.0	252.0	256.6
International Affairs (150)	23.2	17.1	17.4	19.8	20.9	21.5
General Science, Space, and Technology (250)	6.6	7.2	7.1	7.2	6.9	7.2
Energy (270)	9.3	9.4	9.4	8.8	9.7	14.4
Natural Resources and Environment (300)	12.4	14.0	15.0	16.0	16.9	17.5
Agriculture (350)	5.4	5.6	6.9	7.3	8.0	9.2
Commerce and Housing Credit (370)	6.8	8.1	7.4	9.2	10.0	10.5
Transportation (400)	24.0	23.7	25.6	27.0	28.7	30.5
Community and Regional Development (450)	10.3	9.5	10.5	11.2	12.0	12.7
Education, Training, Employment, and Social Services (500)	33.2	36.9	40.2	43.4	46.0	48.6
Health (550)	72.5	85.7	94.9	104.8	116.8	131.9
Income Security (600)	256.7	283.7	311.8	333.6	367.2	394.8
Veterans' Benefits and Services (700)	23.3	25.5	27.1	28.4	29.6	30.7
Administration of Justice (750)	4.4	4.9	5.3	5.7	6.0	6.4
General Government (800)	4.9	5.5	6.0	6.4	6.8	7.1
General Purpose Fiscal Assistance (850)	6.1	6.4	6.6	7.1	7.5	7.9
Interest (900)	79.9	88.0	88.6	89.2	87.6	87.3
Allowances (920)	--	--	--	--	--	--
Undistributed Offsetting Receipts (950)	-28.9	-33.7	-39.8	-46.0	-52.4	-57.2
Total	723.8	795.6	859.3	916.8	980.3	1,037.7

TABLE 20. BASELINE PROJECTIONS OF OUTLAYS, BY FUNCTION (By fiscal year, in billions of dollars)

	1981 Base	Projections				
		1982	1983	1984	1985	1986
National Defense (050)	159.6	183.8	203.5	222.0	238.8	254.0
International Affairs (150)	11.0	11.4	12.1	13.1	13.7	14.3
General Science, Space, and Technology (250)	6.3	7.0	7.1	7.1	7.0	7.1
Energy (270)	9.8	11.4	12.0	10.9	11.1	13.7
Natural Resources and Environment (300)	13.7	14.3	15.0	15.6	16.2	16.8
Agriculture (350)	2.9	6.5	6.9	7.8	9.3	11.0
Commerce and Housing Credit (370)	3.5	6.4	5.8	5.8	6.1	6.6
Transportation (400)	23.4	22.6	24.4	25.8	27.6	29.4
Community and Regional Development (450)	11.7	11.1	9.9	10.4	11.0	11.7
Education, Training, Employment, and Social Services (500)	32.9	35.9	38.5	41.4	44.1	46.6
Health (550)	66.3	76.6	86.0	96.3	107.0	118.3
Income Security (600)	228.6	255.7	277.8	296.7	318.3	338.9
Veterans' Benefits and Services (700)	22.8	25.1	26.8	28.1	29.4	30.5
Administration of Justice (750)	4.6	5.0	5.2	5.6	6.0	6.3
General Government (800)	4.8	5.4	5.8	6.4	6.6	6.9
General Purpose Fiscal Assistance (850)	6.8	6.4	6.6	7.0	7.4	7.8
Interest (900)	79.9	88.0	88.6	89.2	87.6	87.3
Allowances (920)	--	--	--	--	--	--
Undistributed Offsetting Receipts (950)	-28.9	-33.7	-39.8	-46.0	-52.4	-57.2
Total	659.8	738.7	792.5	843.3	894.9	949.9

share of total baseline outlays to about 27 percent by 1986. Another function that is projected to grow faster than total budget outlays under baseline assumptions is the health category (function 550), largely because cost increases are assumed to continue to be more rapid for the medicare and medicaid programs than for other domestic programs. Health outlays are projected to grow from 10 percent of total outlays in 1981 to 12.5 percent by 1986 under continuation of existing spending policies.

Declining shares of the budget are projected for the interest and undistributed offsetting receipts categories (functions 900 and 950), which together would fall from about 8 percent of total outlays in 1981 to about 3 percent in 1986. The relative shares of total budget outlays for the remaining functional categories would remain essentially unchanged during 1982-1986 under the CBO baseline assumptions.

The relationship between the five spending categories used earlier in this chapter to discuss the spending projections and the functional classification is as follows:

- o The national defense category is the same for both classifications.
- o The bulk of benefit payments for individuals are classified in the health, income security, and veterans' benefits and services categories (functions 550, 600, and 700).
- o Grants to state and local governments (other than grants for payments for individuals) are found in functions 300, 400, 450, 500, and 850.
- o Net interest consists of the interest category (function 900) and the interest received by trust funds, which constitute approximately one-half of the undistributed offsetting receipts category (function 950).
- o Other federal operations are distributed throughout all functional categories except national defense and interest.

BUDGET RESOLUTION SPENDING TARGETS

The first budget resolution for 1982 proposes a sharp reduction in the annual growth rate of federal spending and a dramatic change in spending priorities. The budget resolution spending targets would hold the annual growth in federal outlays to 5.4 percent for the next three years